Supreme Court, U.S.
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No. 00-991

IN THE

Supreme Court of the United States

WALTER A. FORBES and CHRISTOPHER McLEOD,

Petitioners,

v.

GEORGE SEMERENKO, *et al.*,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF IN OPPOSITION FOR RESPONDENTS GEORGE SEMERENKO, *et al.*

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QUESTION PRESENTED

Whether section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, are intended to apply to fraudulent statements made by a tender offeror to a class of purchasers of target company stock who suffered damages as a result of those fraudulent statements.

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STATEMENT OF THE CASE

A. The Underlying Litigation

Respondents, George Semerenko, *et al.*, are members of a class of persons who purchased shares of ABI stock after the announcement by Cendant that it had commenced a tender offer for ABI shares. App. 2a. Cendant was the victor after an ensuing takeover battle for ABI because its fraudulent financials enabled Cendant to portray itself as a sound company with a strong financial history. People believed that Cendant's market value reflected its true financial condition. App. 3a.

ABI shareholders were to receive a combination of Cendant stock and cash as consideration for their ABI shares in the merger. App. 3a. Respondents, like many other investors, purchased ABI stock reasonably believing that its price reflected not just ABI's value as a stand-alone company, but the true value of Cendant and the to-be combined company as well. However, ABI's price was artificially inflated by defendants' massive fraud. The revelation of the fraud, and ultimately the termination of the merger, caused huge losses to ABI investors. App. 3a, 6a.

B. Factual Background

Respondents (members of a putative class) purchased shares of American Bankers Group, Inc. ("ABI") stock following the January 27, 1998 announcement by Cendant Corporation ("Cendant") that it had commenced a tender offer for ABI for $58 per share in cash and Cendant stock. App. 3a. This followed a $47 per share offer by American Insurance Group, inc. ("AIG"). App. 3a. In connection with its tender

offer, Cendant filed a Schedule 14D-1 with the Securities and Exchange Commission ("SEC") that materially overstated its income in previous reporting periods. App. 3a.

Cendant thereafter topped a $58 per share AIG bid with an offer of $67 per share in cash and Cendant common stock. App. 3a. The Cendant-ABI merger agreement was announced in Cendant's March 23, 1998 press release. On that day, Cendant filed an amended Schedule 14D-1 with the SEC.

On March 31, 1998, defendants[1] caused Cendant to file its Form 10-K for the year ended December 31, 1997, which included audited financial statements which were fraudulent. On April 15, 1998, Cendant announced that it had discovered potential accounting irregularities "limited" to a single business unit that "accounted for less than one third" of Cendant's 1997 net income. App. 4a. As a result of the April 15, 1998 announcement which, as the Complaint alleges, did not fully disclose Cendant's true financial condition, the ABI stock price sank 11% from $64-7/8 to $57-3/4. App. 4a.

Following the April 15, 1998 announcement, Cendant issued several statements aimed at convincing the market of its commitment to the ABI merger in order to draw in ABI shares for its tender offer and concomitantly, to maintain the price of Cendant's stock. Cendant stock was being used as part of the currency to purchase ABI shares. For example, an April 27, 1998 letter to Cendant's shareholders, signed by Petitioner Forbes and Cendant's President and Chief Executive Officer emphasized that: the problems were

1. Petitioners here are two of the four individual defendants named in plaintiffs' complaint. Cendant and Ernst & Young LLP ("E&Y") were also named. Only Petitioners seek a writ of certiorari.

"limited" in scope; that Cendant was "strong, highly liquid and extremely profitable"; that the "vast majority" of Cendant's earnings and operating businesses were "unaffected and the prospects for the Company's future growth and success are excellent;" and reaffirmed Cendant's commitment to the ABI transaction. App. 5a. On the same day, the Cendant defendants caused the Company to state that it saw "no problem" in completing the merger by late summer. As alleged in the Complaint, this and similar subsequent statements caused class members to purchase ABI stock at artificially inflated prices.

In a May 8, 1998 press release announcing Cendant's earnings for the quarter ended March 31, 1998, the Cendant defendants said that over eighty percent of Cendant's first quarter 1998 net income came from Cendant business units not impacted by the potential accounting irregularities. App. 5a. Both this statement and the statements made on April 27 concerning the limited impact of the accounting irregularities were alleged to be knowingly or recklessly materially false and misleading.

On July 14, 1998, Cendant revealed that the 1997 restatement would have a greater impact on its financial statements than previously announced. App. 5a. Thereafter, in order to convince the market that it would proceed with the merger, the Cendant defendants repeatedly committed to complete the ABI merger, thus "buoying" ABI's market price. App. 5a. Cendant also announced extensions of its tender offer, as it had done on prior occasions. On August 13, 1998, Cendant announced that the investigation into the accounting problems was complete and that it would restate its 1995 through 1997 financials. On August 31, 1998, immediately following the August 28, 1998 release of the Report to the

Audit Committee of the Board[2] describing the outcome of the investigation, Cendant announced an extension of its tender offer to October 1, 1998. A copy of the Audit Report was forwarded to the United States Attorney for the District of New Jersey. App. 6a. On October 1, 1998, Cendant again extended the tender offer until November 2, 1998 and filed its corresponding 14D-1 amendment with the SEC.

On October 13, 1998, the termination of the ABI-Cendant merger was announced. By then, Cendant's stock price had dropped to a level where, rather than being accretive to Cendant's earnings within the first year as promised, the ABI transaction had to be aborted because it would be so highly dilutive to Cendant's shareholders. As a result of hard bargaining between the putative merger partners, ABI managed to extract a $400 million penalty payment from Cendant — payment for which no provision was made in the merger agreement. App. 6a. No portion of this penalty was ear-marked for ABI shareholders.

Class members lost enormous sums of money as a result of defendants' fraudulent conduct. ABI's share price plummeted from $64-7/8 per share on March 23, 1998 to $35-1/2 per share on October 13, 1998. App. 6a. As the Complaint states, defendants' misstatements and omissions created an unrealistically positive assessment of Cendant and its financial condition and the benefits of the proposed merger to ABI, causing ABI's stock to be overvalued and inflated, and class members purchased their stock at those inflated prices. App. 3a. Plaintiffs were induced to purchase ABI stock and tender it to Cendant believing they would reap the rewards of the accretive merger promised by Cendant.

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2. That report detailed the wrongs committed at Cendant and identified various individuals who should bear responsibility for what happened, including Petitioner Forbes.

SUMMARY OF THE ARGUMENT

Petitioners seek broader immunization from the reach of the securities laws for the makers of fraudulent tender offers. They seek a rigid rule that ABI shareholders cannot have recourse for financial fraud because they were purchasers of stock of the company that was the target of the Cendant fraudulent tender offer, rather than of the offeror itself. This argument makes no legal or logical sense since Cendant's publicly disseminated, admittedly fraudulent financial information was used to persuade ABI investors specifically, and the market in general, of the value of Cendant as an enterprise and of the desirability of owning shares in the merged entity. Thus, defendants led people to believe that the exchange of ABI stock for cash and shares of Cendant (and thus, a stake in the merged entity), would be a prudent investment decision.

REASONS FOR DENYING THE WRIT

A. The Third Circuit's Decision is Consistent with Other Circuits' Application of Supreme Court Precedent

A determination whether the "in connection with" requirement has been satisfied requires a very fact-specific inquiry. The Third Circuit's decision does not deviate from the rule of law espoused by this Court in *Superintendent of Insurance of State v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971), when it found that an injury had been suffered "as a result of deceptive practices touching its sale of securities as an investor." In *Bankers Life*, this Court held: "Since there was a 'sale' of a security and since fraud was used 'in connection with' it, there is redress under § 10(b)."

404 U.S. at 12. As said in *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 595 (5th Cir.) *cert. denied*, 419 U.S. 873 (1974), "The Court made it clear that a direct or close relation between the fraud and the securities transaction was not required."[3] Consistent with *Bankers Life*, which held that Section 10(b) must be read "flexibly, not technically and restrictively", this Court opined, in *United States v. Naftalin*, 441 U.S. 768, 773 (1979) that "Congress expressly intended" to define the statutory terms in the federal securities laws "broadly".

Although Petitioners advocate a single "one size fits all" standard, even their own authority points out the "multiplicity of fact situations" in which the "in connection with" requirement arises, and the necessity for judges "to vary their analyses depending on the type of case involved". C. Edward Fletcher, *The "In Connection With" Requirement of Rule 10B-5*, 16 Pepp. L. Rev. 913, 917-918 (1989). In fact, the author acknowledges that "corporate mismanagement cases must be treated differently from misappropriation/insider trading cases when analyzing the degree of connection between the deception and the purchase or sale of securities." *Id.* Similarly, courts have remarked about the importance of fleshing out the appropriate standard on a case-by-case basis. *Smallwood*, 489 F.2d at 595; *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 942 (2d Cir.) *cert. denied*, 469 U.S. 884 (1984).

In considering what standard to apply here, the Third Circuit looked to prior "in connection with" decisions within

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3. In *Smallwood*, the court explained that *Bankers Life* "permitted a purchase by the plaintiff in one transaction to create standing to allege a violation of Rule 10b-5 in a different transaction when both transactions were alleged to be part of a single fraudulent scheme." 489 F.2d at 595.

the Circuit, and determined that they provided no guidance since they did not involve the "public dissemination of allegedly misleading information into an efficient securities market." App. 14a. The Circuit Court did observe, however, that those cases "are illustrative of the point that the 'in connection with' language requires a causal connection between the claimed fraud and the purchase or the sale of a security, and that the misrepresentations need not refer to a particular security." App. 14a.

The Third Circuit then looked to *In re Ames Dep't Stores Inc. Stock Litig.*, 991 F.2d 953, 965-966 (2d Cir. 1993) and *McGann v. Ernst & Young*, 102 F.3d 390, 392-393 (9th Cir. 1996), *cert. denied*, 520 U.S. 1181 (1997), which it identified as having recently addressed the scope of the "in connection with" requirement in the context of the public dissemination of false and misleading information. App. 15a.[4] The Third Circuit observed that those courts, like the Third Circuit, adopted the objective analysis of *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968), *cert. denied*, 394 U.S.

4. Other cases Respondents were able to identify that considered the issue have read the "in connection with" language to allow persons induced to buy or sell stock as a result of public misrepresentations made by someone not a part to the sale to sue that person for damages incurred as a result of the sale. *G&M, Inc. v. Newbern*, 488 F.2d 742 (9th Cir. 1973); *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910, and *cert. denied*, 414 U.S. 924 (1973); *In re Gulf Oil/Cities Serv. Tender Offer Litig.*, 725 F. Supp. 712 (S.D.N.Y. 1989); *In re Phillips Petroleum Sec. Litig.*, 697 F. Supp. 1344 (D. Del. 1988), *vacated on other grounds*, 881 F.2d 1236 (3d Cir. 1989); *In re Nextel Communications Sec. Litig.*, Civil Action No. 94-4213 (July 23, 1997) (*See* Lodging Appendix submitted herewith); *Braun v. Northern Ohio Bank*, 430 F. Supp. 367 (N.D. Ohio 1977); *Crofoot v. Sperry Rand Corp.*, 408 F. Supp. 1154 (E.D. Cal. 1976).

976 (1969) which considers a misrepresentation in context, i.e. "Rule 10b-5 is violated whenever assertions are made . . . in a manner reasonably calculated to influence the investing public . . ."[5] While this Court has never directly addressed the *Texas Gulf* test's validity, it did favorably quote from *Texas Gulf's* interpretation of the "in connection with" requirement in its opinion in *Basic Inc. v. Levinson*, 485 U.S. 224, 235 n.13 (1988).

The Third Circuit held, consistent with those Second and Ninth Circuit cases, that to establish the "in connection with" requirement, one must show that "misrepresentations were disseminated to the public in a medium upon which an investor would rely, and that they were material when disseminated." App. 16a. In the Third Circuit's view, this rule recognized "the realistic causal effect that material misrepresentations, which raise the public's interest in particular securities, tend to have on the investment decisions of market participants who trade in those securities." App. 16a.

B. The Conflict Among Circuit Courts Necessary to Confer Jurisdiction on this Court Does Not Exist Here

Petitioners contend that the Third Circuit's standard here conflicts with the Second Circuit's standard in *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984) and case law in the Fourth and

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5. Several other circuits have adopted the *Texas Gulf* interpretation of the "in connection with" requirement. *Akin v. Q-L Investments, Inc.*, 959 F.2d 521, 528 (5th Cir. 1992); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 100-01 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); *SEC v. Savoy Industries, Inc.*, 587 F.2d 1149, 1171 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979).

Seventh Circuits. Petitioners describe that standard as requiring that the alleged fraud "pertain to the relevant securities purchased or sold or the consideration for them" and the "fraud must have induced the transaction." Petitioners' Br. at 11.

That standard does not conflict with the Third Circuit's standard here because it simply was not intended to apply to a public dissemination case. *Chemical Bank* involved the fraudulent procurement of a loan from a bank where the loan was collateralized with a security. In *Chemical Bank*, the Second Circuit held that § 10(b) does not provide a remedy for misrepresentations if the direct result of the misrepresentation is a loan and not a securities transfer. The court noted the limited scope of its holding, specifically differentiating between situations in which alleged misrepresentations induce plaintiffs to part with pledged property, and misrepresentations which simply induce the plaintiffs to make a loan collateralized by a pledge of securities that were not the subject of the misrepresentations. 726 F.2d at 944. The *Chemical Bank* decision serves to ensure that § 10(b) claims are limited to cases involving securities.[6] This concern was the subject of the Third Circuit's discussion

6. Petitioners contend that this case presents an issue left unresolved in *Rubin v. United States*, 449 U.S. 424 (1981) — whether "misrepresentations or omissions involved in a securities action but not pertaining to the securities themselves" can form the basis of a violation of the securities laws. *Id.* at 429 n.6. The issue in *Rubin* — did the subject misrepresentation relate to the security being pledged itself or the underlying collateral — is not at issue here, although it has been in other cases. *See Chemical Bank*, 726 F.2d at 943 n.22 (where the court said it was "compelled to decide that question"). *See also, Head v. Head*, 759 F.2d 1172 (4th Cir. 1985); *Ketchum v. Green*, 557 F.2d 1022 (3d Cir.), *cert. denied*, 434 U.S. 940 (1977).

in *Angelastro v. Prudential-Bache Sec., Inc.*, 764 F.2d 939, 946 (3d Cir.), *cert. denied*, 474 U.S. 935 (1985) where the Court observed that:

> The Second Circuit was concerned that every bank loan partially secured by the pledge of stock might fall within the scope of section 10(b). We also agree that too broad an interpretation of § 10(b) is unwarranted. Misrepresentation of the credit terms of a margin account, which is what purportedly occurred here, is a different situation from that in Chemical Bank, and clearly meets the "in connection with" requirements.

Petitioners argue that since the Fourth and Seventh Circuit have adopted the *Chemical Bank* standard for review of the "in connection with" requirement, there is a split among the Circuits as to what that standard is. However, neither *Head v. Head*, 759 F.2d 1172 (4th Cir. 1985) nor *Gurwara v. Lyphomed, Inc.*, 937 F.2d 380 (7th Cir. 1991), which Petitioners cite for that proposition, involves public dissemination of material misrepresentations. In *Gurwara*, an employer's representation about its employee's eligibility to exercise a stock option was found to have related only to his opportunity to purchase at the described prices, but did not affect the value of the stock. *Head* involved a divorce settlement. The Court rejected the wife's argument that the settlement was a "sale" of stock and ruled that a pledge of stock to secure her husband's debt under the settlement agreement failed to satisfy the "in connection with" requirement. These cases simply acknowledge the accepted proposition that not all misrepresentations fall within the

scope of the relationships contemplated by the federal securities laws.[7]

Petitioners offer no real evidence of the purported "split" among the Circuits since they cite no cases outside the Second and Ninth Circuits which relate to the type of fraud addressed by the Third Circuit below. Instead, they direct this Court to cases where no parallel can be drawn. They also attempt to support this argument with the contention that this split exists among the district courts in the Second Circuit. Not only is this position belied by Petitioners own examples — *Production Resource Group, LLC v. Stonebridge Partners Equity Fund, L.P.*, 6 F. Supp. 2d 236 (S.D.N.Y. 1998) and *Aiena v. Olsen*, 69 F. Supp. 2d 521 (S.D.N.Y. 1999) — these examples show decisional consistency and do not evidence any type of split. Even if they did, such a split could not form the basis of this Court's jurisdiction under Supreme Court Rule 10 because they are not circuit court cases.[8]

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7. In *Ketchum v. Green*, 557 F.2d at 1027, the court said that after *Bankers Life*, the courts have tended to construe the "in connection with" requirement broadly. Interestingly, the *Ketchum* court cited a Second Circuit and a Seventh Circuit case for that proposition, *Jannes v. Microwave Communications, Inc.*, 461 F.2d 525, 529 (7th Cir. 1972) and *Drachman v. Harvey*, 453 F.2d 722, 736-38 (2d Cir. 1971) (en banc).

8. In *Production Resource Group*, the court found that since the alleged misrepresentations related only to whether defendants were actually engaged in negotiations with plaintiff about the sale of their company and whether they intended to sell their business to plaintiff, rather than the value of the stock of the business, the "in connection with" requirement was not satisfied. 6 F. Supp. 2d at 240. In *Aiena*, on the other hand, defendants allegedly deceived plaintiffs about the value of the corporation's securities plaintiffs were receiving, and the "in connection with" requirement was deemed to have been met. 69 F. Supp. 2d at 536-537.

Petitioners suggest that the Third Circuit's decision here expands the "in connection with" requirement beyond the *Chemical Bank* standard. Yet, a review of the facts of this case measured against that standard points out the fallacy of Petitioners' position.

Cendant sought to acquire all of the stock of ABI via a tender offer, to be followed by a merger. For each share of ABI stock tendered or merged out, the ABI shareholders would receive a combination of cash and Cendant stock. In order to induce ABI shareholders to tender their shares and/or vote for the merger, Cendant made materially false and misleading statements about the value of Cendant and its financial condition. This information was material to current and prospective ABI shareholders because they would retain an interest in Cendant after the two companies merged by virtue of the stock they were to receive as part of the merger consideration. Defendants' misstatements artificially inflated the prices of both Cendant and ABI stock, reflecting the market's belief in the value of the combined entity. Thus, Cendant's alleged misrepresentations resulted in class members' purchases of ABI stock at prices inflated by the fraud. Under the standard advocated by Petitioners, Petitioners' Br. at 11, the fraud alleged here clearly "pertains" to the "securities purchased" and "induced" class members' purchases of ABI stock.

Petitioners' arguments demonstrate that no great schism exists among the circuit courts to warrant this Court's review. To the contrary, the courts are well aware of the need to, and well-equipped to address, the varying fact patterns presented to them. Given the seemingly endless number of creative ways to devise fraudulent schemes, a "one size fits all" standard would be unworkable. Petitioners urge this Court

to adopt a standard that would fit some situations, but certainly not this one.

The Third Circuit did not "widen the net" for securities fraud allegations. It simply articulated a standard to be applied under this particular set of circumstances — public dissemination of materially false and misleading information. In so doing, the Third Circuit acknowledged a fundamental principle: that a central goal of the securities laws' disclosure provisions is to promote fairness and efficiency in the securities markets. *See Cent. Bank of Denver, N.A. v. First Investor Bank of Denver, N.A.*, 511 U.S. 164 (1994).

CONCLUSION

For all of the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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